No. 16,150

In the United States Court of Appeals for the Ninth Circuit

MORTIMER A. KLINE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

GORDON OIL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decisions of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 38-59) are reported in 29 T.C. 1110.

JURISDICTION

This case involves Mortimer A. Kline's individual income tax liability for calendar year, 1951 (R. 24), as transferee of Gordon Oil Company for deficiencies in income and excess profits taxes in the amount of $46,256.88 for the corporation's taxable period January 1, 1951, to August 31, 1951 (R. 60, 61). Notice of the deficiency (R. 12-13) was mailed to Gordon Oil Company on January 18, 1955 (R. 6). On April 8, 1955, within the permitted ninety-day period provided in Section 272 of the Internal Revenue Code of 1939, both petitioners (R. 3, 4) filed petitions for review with the Tax Court for a redetermination of the deficiencies (R. 6-8, 9-11). The decisions of the Tax Court, sustaining the corporate income and excess profits tax liability for the taxable period and Mortimer A. Kline's individual tax liability, as transferee, were entered on March 19, 1958. (R. 60, 61.) Petitions for review by this Court were timely filed on June 9, 1958. (R. 62-68, 68-73.) Pursuant to joint motion filed with this Court (R. 76-77), the two cases were consolidated for briefing, hearing, argument and decision (R. 77-78). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court erred in holding that Gordon Oil Company [1] failed to sustain the burden of

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[1] The deficiency determined against Gordon Oil Company was also asserted against petitioner Mortimer A. Kline as

proving a claimed loss on the transfer of oil and gas leases and related equipment, in consideration for cash and a reserved oil payment.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

* * * *

(f) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*— The amount realized from the sale or other disposition of property shall be the sum of any money received plus the

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transferee of the assets of that corporation. Since Kline does not contest his liability as transferee if the corporation is liable for the deficiency (R. 59), for convenience the petitioners are sometimes referred to as "taxpayers".

> fair market value of the property (other than money) received.
>
> * * * *
>
> (26 U.S.C. 1952 ed., Sec. 111.)

STATEMENT

The pertinent facts, as stipulated (R. 24-27) and as found by the Tax Court below (R. 38-56), appear as follows:

Mortimer A. Kline is an individual residing in Los Angeles, California. He filed his income tax return for the taxable year ended December 31, 1951, with the Collector of Internal Revenue at Los Angeles, California. (R. 39.)

Gordon Oil Company was incorporated under the laws of the State of California on January 20, 1949. It was incorporated for the purpose of acquiring, exploring, developing and producing oil and gas properties, and throughout the period of its existence conducted that business. Gordon filed its income and excess profits tax returns for the taxable period January 1, 1951, to August 31, 1951, with the Collector of Internal Revenue at Los Angeles, California. (R. 40.)

Gordon, on March 22, 1949, acquired two undeveloped oil and gas leases in Placerita Field, Los Angeles County, California. Gordon drilled and equipped twenty-nine producing wells on the leaseholds. (R. 40.)

During the period from March to May, 1951, Kline purchased all of Gordon's outstanding stock for a total consideration of $3,962,432.54. Kline purchased

the stock for his own account. The purchases were financed by a loan from a bank in Dallas, Texas. All of the stock in Gordon purchased by Kline was pledged as collateral for the loan. (R. 40.)

After Kline had acquired control of Gordon, Gordon, as a principal, by proper and appropriate corporate action, executed under date of May 7, 1951, an agreement with Tevis F. Morrow and A. H. Meadows. Upon the execution of this agreement there was paid to Gordon $250,000 in cash. (R. 40-41.) The agreement provided for payment by the assignees Morrow and Meadows, in addition to the $250,000 cash down payment, of a reserved oil payment to Gordon Company in the amount of $3,600,000, and for various other covenants to be performed by Morrow and Meadows. The relevant provisions of the agreement are set out in the Tax Court's opinion at pages 41 to 54 of the record.

The excepted interest reserved by Gordon in the agreement with Morrow and Meadows would be liquidated in full substantially prior to the exhaustion of the economic life of the leases and was not tantamount to an overriding royalty. (R. 54.)

At the time of the agreement with Morrow and Meadows, Gordon had fully depleted its leasehold cost in both of the leases, but had on hand tangible assets pertaining to the operation of the leases, with a then adjusted basis of $332,518.70. These assets, their respective costs to Gordon, adjustments due to depreciation, and their adjusted basis were as follows, as of the date of the agreement (R. 54-55):

Physical equipment in wells	$159,748.52
Buildings	8,147.12
Machinery and equipment	5,414.27
Pipelines	18,909.76
Pumping equipment	94,745.87
Reservoirs and tanks	25,725.35
Autos and trucks	7,200.05
Total	$319,890.94
Less reserve for depreciation	37,429.80
Adjusted basis of fixed assets	$282,461.14
Crude oil inventories— at book amount	13,215.15
Materials and supplies— at book amount	34,204.04
Electrical service deposits	2,638.37
Total Adjusted Basis of Properties Sold	$332,518.70

Kline, on behalf of Gordon, negotiated the sale of the working interest in the leasehold estates and the sale of all of its other properties except cash and accounts receivable with Morrow and Meadows. Morrow and Meadows never had any connection with Gordon was an officer, stockholder, director or otherwise. (R. 55.)

Following the execution of the agreement with Morrow and Meadows, Gordon was dissolved and all of its assets and property then on hand, including the excepted interest, were distributed in complete liquidation of the company to Kline in cancellation and redemption of all of the outstanding stock of the company. (R. 55.)

After Gordon was dissolved and liquidated, Kline, as a principal, sold the excepted interest which he had received in liquidation of Gordon for $3,600.000, to a purchaser with whom he never had any prior connection. Following the liquidation of Gordon and the sale of the excepted interest, Kline paid off the indebtedness he had incurred with the Dallas bank in connection with his purchase of all of the outstanding capital stock of Gordon. (R. 55-56.)

Kline was the transferee of the assets of Gordon upon its complete liquidation in August, 1951. (R. 56.)

Gordon as a result of the transaction with Morrow and Meadows claimed a loss deduction of $82,518.70. The Commissioner disallowed the deduction, and the Tax Court sustained the disallowance. (R. 56-59.)

SUMMARY OF ARGUMENT

The Tax Court correctly held that the taxpayers had failed to meet the burden of proving the claimed loss. The taxpayers claim a deductible loss on the theory that the equipment and other tangible property used in connection with the leaseholds was sold by Gordon Oil Company separately from the leaseholds, and, moreover, was sold solely for the cash down payment of $250,000. However, the record shows, and the Tax Court found, that the tangible property was transferred in conjunction with the leaseholds as part of a package deal, and in a single instrument of transfer, and that the cash down payment was but a part of the total consideration receivable, the taxpayers having reserved a substantial oil

payment and various covenants as additional consideration. Nothing in the instrument of transfer indicates that the cash down payment was the sole consideration for the tangible property, i.e., that no part of the additional consideration was allocable to the tangible property. Indeed, as the Tax Court also found, there is no convincing evidence that the tangible assets which the taxpayers claim they sold for only $250,000 were worth less than their adjusted basis ($332,518) at the time of the sale. Since the taxpayers failed to carry the burden of proving that the tangible property was sold for only the cash down payment, the Tax Court properly disallowed the claimed loss deduction.

ARGUMENT

The Tax Court Correctly Held That the Taxpayers Failed To Sustain the Burden of Proving the Claimed Loss

The taxpayers are entitled to a loss deduction on the sale of the leasehold equipment (tangible assets) only if the consideration received on the sale was less than the adjusted basis of the property sold. Sections 22(f) and 111(a) and (b) of the Internal Revenue Code of 1939, *supra*. The burden of proving the right to, and the amount of, the claimed deduction rested of course upon the taxpayers. *Burnet* v. *Houston*, 283 U.S. 223, 227; *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440; *Deputy* v. *du Pont*, 308 U.S. 488, 493. This burden, as the Tax Court held upon analysis of the entire record, clearly has not been met. As the Tax Court pointed out in its opinion, the taxpayers'

entire argument proceeds on the unwarranted premise that the tangible property sold in conjunction with the leaseholds was sold separately from the leaseholds, and, moreover, was sold solely for the cash down payment of $250,000. However, as the record shows and the Tax Court found (R. 56-57), the cash payment "was part of an *integrated transaction* involving an assignment of the working interests in two producing oil and gas leases *along with all related assets* except cash and accounts receivable", and "Nowhere in the instrument of assignment is there any language indicating either explicitly or by implication that the $250,000 cash payment was the *sole consideration* for the tangible property."[Italics ours.] In the words of the Tax Court (R. 56, 58-59):

> But the difficulty with petitioners' position is that the record fails to support their assumption that the tangible property was sold for $250,000, and there is no convincing evidence that the consideration passing to the seller in respect of the tangible property was less than its adjusted basis.
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> * * * *
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> And if there was a cash payment, as in the present case, there must be some satisfying proof that it represented the sole consideration for the tangible assets before the assignor can succeed in its claim that it suffered a deductible loss, measured by the excess of the adjusted basis over the cash payment. Otherwise, merely by juggling the cash payment and the so-called retained interest, it would be able to obtain a deduction on account of a loss that it in fact did not sustain. * * *

> Petitioners merely assert, without proof, that the consideration consisted solely of the $250,000 cash payment. The burden of proof, however, was upon them, and they have completely failed to carry it. There is no convincing evidence that the tangible assets were worth less than their adjusted basis at the time of sale, or that the seller negotiated a deal whereby the total consideration receivable in respect of such assets was less than their adjusted basis. One who claims a deduction on account of loss must establish his right to it.

Viewed in a light most favorable to the taxpayers, all that the record shows is that: (a) Kline purchased Gordon Oil Company's stock for $3,962,432.54 (R. 25); (b) Gordon Oil Company then assigned its entire interest in its producing oil properties (including tangible properties but excluding accounts receivable and moneys on hand or on deposit) to Meadows and Morrow in return for an oil payment of $3,600,000, payable out of 85 per cent of production and for cash of $250,000 (R. 25-26, 41-54); (c) the adjusted basis of the assigned tangible property was $332,518.70 (R. 26); (d) after dissolution of Gordon Oil Company and distribution of its assets to himself, Kline sold the oil payment to a purchaser at par (R. 35, 55-56); Gordon Oil Company, on the Meadows and Morrow assignment, intended to dispose of all its interest in the physical equipment (R. 35); the $250,000 cash payment was a product of negotiation "and in my [Kline's] judgment that represented the fair market value of the equity, subject to the oil payment" (R. 35); and (e) Gordon Oil Company ac-

quired the leases in an undeveloped state and equipped twenty-nine wells (R. 37), placing the equipment on the properties prior to Kline's acquisition of the stock (R. 36). Kline acknowledged (R. 34-35) that the instrument of assignment (R. 25-26, 41-54) was the best evidence of the interest conveyed to Morrow and Meadows; significantly, the granting clause of that instrument recited (R. 41):

> For a valuable consideration, cash in hand paid * * * and in consideration of the strict and punctual performance by Assignee * * * of the covenants herein provided to be kept and performed by Assignee * * * and, subject to the exception and reservation hereinafter stated,[2]

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[2] This "exception and reservation" consisted of the $3,-600,000 oil payment payable out of 85 per cent of production, plus reimbursement of any taxes paid by Assignor, and plus 5 per cent per annum interest from May 1, 1951, on the unliquidated balance. (R. 42-44.) In addition, the agreement provided (R. 45):

> (7) The above reservation and exception shall in no sense extend to any lease equipment or other personal property which is included in this sale, all of which equipment and personal property is being sold to Assignee without reservation.

See also paragraphs 8 and 10 of the assignment (R. 45-50) setting out the assignee's covenants to develop and operate the properties in a good and workmanlike manner and to produce oil and gas as long as possible in paying quantities; pay over the assignor's share; pay taxes, costs and expenses; comply with all leases and regulations; and granting to the assignor visitorial privileges and rights to inspection. As the Tax Court observed (R. 57), "These covenants were plainly of considerable value to the assignor."

> Assignor does hereby * * * assign * * * all interests in lands wherever situated and all * * * rights of every character which are useful or appropriate in exploring for, developing, operating, treating, storing, or transporting oil, gas or other minerals * * * together with all improvements and all the interests of Assignor in all personal property situated upon or used in connection with mining operations on said lands, and all other tangible personal property or interests therein now owned by Assignor, and all other properties and interests in properties of whatsoever kind or character, except accounts receivable and moneys on hand or on deposit; now owned by Assignor.

According full significance to each and all of the above outlined facts, it becomes clear, as the Tax Court concluded (R. 56, 58-59), that the taxpayers have failed completely to sustain the burden of proving the claimed $82,518.70 loss deduction on the sale of the tangible property. The fact that the tangible property had an adjusted basis of $332,518.70 has no significance for purposes of establishing the claimed $82,518.70 loss unless proof were adduced that the $250,000 received in cash was the sole consideration paid specifically for such property. However, as the Tax Court pointed out (R. 57-58):

> Nowhere in the instrument of assignment is there any language indicating either explicitly or by implication that the $250,000 cash payment was the sole consideration for the tangible property. A reading of the instrument as a whole persuasively suggests that it represented a "package deal", and we have no way of know-

> ing on the record before us whether a proper allocation of the total consideration running to the assignor in respect of the tangible property includes something more than the $250,000 cash payment.
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> Obviously, the parties could easily have varied the amount of the immediate cash payment with appropriate accompanying changes in the consideration relating to the so-called reserved payment. Or, they might even have eliminated the immediate cash payment entirely while at the same time providing for increased consideration in respect of the other covenants. Could it fairly be said in such circumstances that the tangible property was being sold for nothing? The answer is plainly no. The transaction was a matter of negotiation between the parties, and it was entirely up to them as to whether there would be any immediate cash payment or the amount thereof.

Moreover, a mere cursory reading of the entire instrument of assignment, and, particularly, the granting clause, *supra*, reveals the absence of any allocation of the consideration (cash down payment plus reserved oil payment) as between the leaseholds and the tangible property. In the absence of evidence that a portion of the reserved oil payment and related covenants was not properly allocable to the tangible property, the taxpayers failed to carry the burden of proving that the tangible property was sold for only the cash down payment, and the Tax Court's decision must be sustained.

Contrary to the taxpayers' contention (Br. 20, 30), the provision in the assignment agreement that the

reserved oil payment was to be made only out of oil production and not out of the proceeds of the sale of the tangible property (R. 45), does not require a finding that no part of the additional consideration represented by the oil payment right and other covenants of the assignees was attributable to the tangible property. The reservation of oil payments out of oil production was obviously a precautionary clause designed to preserve the Gordon Company's economic interest in the oil to be produced, for depletion deduction purposes, to the full extent of the $3,600,000 oil payment. See Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Secs. 23 and 114); *Anderson* v. *Helvering*, 310 U.S. 404. But it hardly follows that no part of the consideration represented by the oil payment was allocable to the leasehold equipment and other tangible property transferred in conjunction with the leasehold. To subscribe to the taxpayers view would, as the Tax Court observed (R. 58), permit the assignor "merely by juggling the cash payment and the so-called retained interest * * * to obtain a deduction on account of a loss that it in fact did not sustain." See also G.C.M. 23623, 1943 Cum. Bull. 313; Rev. Rul. 55-35, 1955-1 Cum. Bull. 286.

The basic fallacy in the taxpayers' argument, as was true of their contention before the Tax Court, is "their assumption that the tangible property was sold for $250,000". (R. 56.) This assumption, in turn, rests upon the fallacious contention (Br. 20, 21, 22-23, 29, 31) that the $250,000 cash payment was the *only* consideration moving to Gordon Oil Company

from the assignees, a contention contrary not only to the express statement of the consideration set forth in the granting clause (R. 41), but to the terms of the agreement read as a whole. Nor is there any merit in taxpayers' attempt to disparage the value attaching to the additional covenants (R. 57) by characterizing such additional consideration as (Br. 29) "attributes of the production payment received by Gordon." The obvious, albeit not precisely calculable, dollar value of the covenants is readily seen when it is recognized that failure to perform subjects the assignees to interest of 5 per cent per annum on the unliquidated balance (par. 4(b), R. 43), which, absent performance at all, would amount to $180,000 in the first year. Under such circumstances, it is unrealistic for the taxpayers to contend that the $250,000 cash down payment was the only consideration. The assignees were, realistically, paying $3,850,000 (and securing a depletable economic interest in the $3,600,000 oil payment) for Gordon's entire interest (less accounts receivable and cash) in the producing leases.

Moreover, as the Tax Court noted (R. 58-59), "There is no convincing evidence that the tangible assets were worth less than their adjusted basis ($332,518) at the time of sale, or that the seller negotiated a deal whereby the total consideration receivable in respect of such assets was less than their adjusted basis." It is entirely unrealistic for the taxpayers to contend, as they do, that the equipment was sold separately from the leases for an amount ($250,-000) substantially less than its fair value. Signifi-

cantly, Kline testified (Br. 22) that the $250,000 down payment represented "the fair market value of the equity (the working interest in the two leases and the tangible property) subject to the oil payment." Apart from the fact that the Tax Court was not obliged to accept any self-serving opinion of value, Kline's testimony appears inconsistent with his present claim that the $250,000 represented the consideration for the tangible property *alone*, and that consequently he sustained a deductible loss in the amount of the difference between the adjusted cost basis of the tangible property ($332,518.70) and the amount received for such property ($250,000), or a loss of $82,518.70.

Nor is there any merit in taxpayers' reliance (Br. 31-36) on *Choate* v. *Commissioner*, 324 U.S. 1. As the Tax Court pointed out below (R. 59):

> No issue was raised in that case as to whether a loss was actually sustained; that fact was assumed, and the Supreme Court explicitly noted that no question was "presented concerning the allocation of a portion of the purchase price to the equipment," 324 U.S. at p. 4. Cf. Theoretical "Loss" On Equipment Arising From Producing Leasehold Assignment, 4 Oil and Gas Tax Quarterly 1, 9-10. The very heart of the present case is whether a loss was in fact sustained, and on that question petitioners have failed to carry the burden of proof.

Finally, in contending (Br. 20, 29) that the "unrecovered cost" of the tangible property must be allowed as a deductible loss or else allowed through

future depletion deductions, the taxpayers beg the very point at issue by assuming that there was an "unrecovered cost", i.e., that the consideration received for the tangible property was less than its adjusted cost basis. There was an "unrecovered cost" only on the assumption that the $250,000 down payment was the *sole* consideration for the tangible property, an assumption which the Tax Court properly declined to accept for failure of proof. See also G.C.M. 23623, 1943 Cum. Bull. 313, *supra;* Rev. Rul. 55-35, 1955-1 Cum. Bull. 286, *supra.*

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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